

cost of service regulation. Indeed, since the benchmark would be established on the basis of generally applicable industry data about capital costs, cable systems which could install plant more efficiently than the benchmark assumed would obtain a benefit, ultimately creating incentives for more efficient capital construction in the cable industry.

Similarly, the *Time Warner-Kelley Study* (p. 17) argues that traditional cost of service regulation skews regulated industries by promoting excessive capital spending. The NAB proposal does not suffer from that vice. Although an allocable per-channel share of new capital equipment would be incorporated into the basic service rate, that would allow recovery of only a portion of the cost of such new equipment. The rest of any investment in upgraded equipment would have to be recovered either from the rates charged for higher tiers or in the prices charged for à la carte or non-cable television services.^{23/} Thus, new capital spending could only be sustained by the cable operator if it were market-justified.

Allowing the basic service benchmark to reflect actual variable costs, moreover, removes incentives for cable operators to restrict the quality of service provided

^{23/} The *Time Warner-Kelley Study* is incorrect in suggesting (pp. 28-29 n.36) that all of the costs of providing service to a household, including the cost of the cable, the cost of providing customer service, etc., be allocated to the basic service tier without regard to the portion of the cable system's channels which are used for basic service. This runs directly counter to the directive in the *Conference Report* (p. 63) that "the basic cable tier should not be required to bear a larger portion of the joint and common costs than what would be required on a per channel basis. The regulated, basic tier must not be permitted to serve as the base that allows for marginal pricing of unregulated services."

to basic tier subscribers and reduces the impetus to move popular cable services to other tiers. Thus, a cost-based benchmark would reduce the desire of cable systems to retier to evade the impact of regulation, and thus lessen the enforcement burden on the Commission and local authorities.

Almost any rate-based benchmark system will be subject to gaming as the *NAB-SPR* study demonstrated. If the Commission establishes a cap for basic service, however constituted, cable systems will be inclined to cut the number of channels which are provided as part of the basic tier until they reach the statutory minimum. If, as many cable operators suggest, the Commission adopts a per-channel benchmark price, cable systems will have every incentive to provide only the least expensive programming on the basic tier to maximize the profits which can be derived from each channel. More expensive programming whose costs approached the benchmark price would all be moved to upper tiers or provided only à la carte. This tendency arising from non-cost based benchmark adjustments is noted in the *TCI-Besen Study* (pp. 34, 48).

NAB's Rate Proposal Meets Every Objective for Basic Tier Regulation

The *TCI-Besen Study* (p. 15) suggests seven principles for a basic tier rate regulation system. The NAB rate proposal satisfies all seven of these requirements.

First, Besen states that any rate regulation system "should take into account differences in the pre-regulation pattern of pricing across systems," including "differences in prices charged by those systems that 'bundle' equipment with service and those that do not."

As discussed above, because the NAB proposal is not dependent upon the rates which any system charged before regulation, there is no need to deal with the bundling of different products and services by cable systems and their impact on current prices.

Second, "the regulatory regime should take into account factors that produce differences in costs among systems."

The NAB proposal allows rates to vary due to differences in programs provided on the basic tier, different operating costs, and technological variations in cable system configurations.

Third, rate regulations should allow for adjustment of rates as "external factors . . . change over time."

External factors which increase the operating costs of a cable system, whether increases in personnel costs, programming, or customer service requirements will be reflected in the rates allowed under the NAB proposal.

Fourth, the "regulatory regime should encourage cable operators to offer higher-quality basic and cable programming and distribution services."

The NAB proposal would allow cable operators adequate compensation for program services carried on the basic tier and an allocable portion of the cost of new capital investment in the system.

Fifth, the system for establishing rates and for adjusting them over time "should be simple enough to be understood by consumers."

Unlike proposals which would establish benchmarks based on prices charged by other cable systems or for putative model cable systems, the benchmarks produced under the NAB proposal would turn on the particular services and conditions of each cable system. The concept of using replacement costs to determine capital costs is understandable by consumers, as is the notion that the portion of other direct costs attributable to the basic service tier should be recovered by cable operators.^{24/}

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By contrast, few consumers will understand or will be comforted by Dr.

(continued...)

Sixth, the regulations should "permit low-cost monitoring and enforcement."

The information needed for the Commission to establish a capital cost matrix is readily available either from the cable industry itself or from industry consultants. The factors which would lead to variations in capital costs (*e.g.*, miles of cable, number of households served, capacity of the system, etc.) are readily determinable by franchise authorities and are not subject to frequent change. The variable costs necessary to determine the basic service rate are obtainable by franchise authorities from cable systems and can readily be documented.

Seventh, "[t]he regime should be flexible enough to avoid the kinds of costly errors that can be made even by well-intentioned regulators."

Although taken to its limits, this principle would counsel against establishing any rate regulation system for fear of unintended consequences, the NAB proposal does not discourage investment in cable plant or programming, does not create incentives for idiosyncratic capital investment, and does not provide encouragement to "game" or evade the rate regulation system. Given the time constraints placed on the Commission in the Cable Act, the Commission cannot expect to achieve complete perfection (were it even possible) in its initial rate regulation approach. The NAB proposal, however, avoids most of the objections raised against other rate regulation proposals.

Even judged by the standards advanced by TCI, adoption of the NAB rate regulation proposal would, therefore, achieve Congress' rate regulation objectives without creating needless regulatory costs to the Commission and the public.

The Basic Service Tier Must be Provided to All Subscribers

Responding to a question posed by the Commission in paragraph 12 of the *Notice*, many cable operators argue that the Act permits them to offer certain services

^{24/}(...continued)

Besen's own proposal that cable systems be allowed periodic "open pricing" seasons as a means of establishing what a regulated rate should be, a system that would in essence provide cable operators with an "open season" to engage in price gouging.

à la carte to subscribers without the basic service tier. *See, e.g.*, Comments of Continental at 10-11; Comments of TCI at 23-36. These comments focus exclusively on the language in § 623(b)(7) which requires subscription to the basic tier as a condition of receiving "any other tier of service." They argue that à la carte services are not tiers and, therefore, that the Act does not require a basic tier "buy-through" before cable operators can provide customers with such individual services.

As NAB pointed out (Comments at 8-9), this argument ignores the separate provision in § 614(b)(7) of the Act which requires that all commercial must carry signals "be provided to every subscriber of a cable system." If a customer receives cable service from a cable system, whether that service is provided on tiers or à la carte, that customer must be viewed as a "subscriber" of the system and all must carry signals provided as part of his or her service. Since must carry signals must be included in the basic service tier under § 623(b)(7)(A), it follows that subscription to the basic service tier is a prerequisite to receiving any cable service.

Cable Operators Should Not be Permitted to Use a Different Definition of Cable System for Rate Regulation than for Must Carry

Finally, section 623(d) of the Act requires cable operators to have uniform rates "throughout the geographic area in which cable service is provided over its cable system." Cable operators in this proceeding urge the Commission to construe this provision narrowly and find that a "cable system" for this purpose refers to specific community units limited by the boundaries of franchise areas. Thus, even if one MSO operated a "technically integrated" system over several franchise areas, that

should not be construed as one cable system requiring the offering of uniform rates across the entire service area. *See, e.g.*, Comments of NCTA at 77-79; Comments of Continental at 59-62; Comments of Time Warner at 70. Continental (Comments at 16) goes further and argues that effective competition should also be gauged on a franchise area basis only.

NAB agrees that the term "cable system" should generally be read as referring to a single franchise area. NAB is concerned, however, that many of these same parties filed comments in MM Docket No. 92-259 arguing that, for purposes of the Act's must carry requirements, technically integrated systems which operate across ADI lines are all one system and should only have must carry obligations to stations in one of the ADIs in which the system operates. *See* Comments of NCTA, MM Docket No. 92-259 at 14 (filed January 4, 1993).

As NAB argued in reply in that proceeding, the Commission should use a common sense definition of "cable system" based on franchise areas and require cable systems to carry the signals of broadcast stations in the ADIs in which they provide service. Reply Comments of NAB, MM Docket No. 92-259 at 5 (filed January 19, 1993). Moreover, while cable operators in the must carry proceeding contended that location of a cable system's headend should be determinative of its must carry obligations, Continental in this proceeding states (Comments at 62) that "franchises are not issued on a headend basis."

The Commission must not permit cable operators to have it both ways. As NAB believes, the term "cable system" should describe a single franchise unit for

both must carry and rate regulation purposes. Cable systems should not be allowed to advocate differing definitions for the same term, adjusted solely to provide maximum advantage for themselves.

Conclusion

In devising a system of rate regulation, the Commission must keep in mind Congress' determination to extract monopoly rents from the prices cable systems charge consumers, particularly for basic service. A system which merely ratifies present rates or which allows cable operators to return to them under one or another guise would not achieve Congress' goal.

Although no rate regulation system can ever be perfect, a system which identifies the real costs of providing cable service and creates a benchmark based on those costs would result in rates close to those which would obtain under competitive conditions and would allow for variations in cable system conditions and services. The Commission would be freed from the necessity of unbundling current cable prices and of determining some factor on which future adjustments could be based, vices which are inherent in any rate-based benchmark system. The NAB proposal also would not present franchise authorities with insurmountable tasks or permit them wide discretion which could be used to unreasonably restrict cable rates.


Finally, whatever system the Commission adopts should not accord different treatment to retransmission consent fees than other cable program costs. If the costs of cable program services are presumed to be incorporated in pre-regulation rates, so should the value represented by retransmission consent agreements. If the cost of

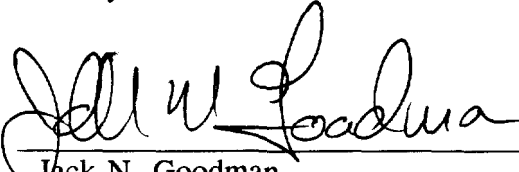
cable program services is recognized in the Commission's rate regulations, then retransmission consent costs should be recognized in the same manner.

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